

Reading the skew

READING THE SKEW

Implied volatility varies across strikes, not just expiries - the skew - and its shape carries information: equity options are usually priced with higher implied volatility on downside strikes, because the market pays more for downside protection and fears crashes more than melt-ups. Reading the skew says what the market fears and where it prices asymmetric risk - the volatility judgement, extended across strikes into the shape of the priced distribution.

The volatility judgement is not one number but a shape across strikes: implied volatility differs by strike, forming the skew, and the skew's shape is the market pricing an asymmetric distribution. Reading it says what the market fears.

The typical equity skew

Equity options usually show higher implied volatility on downside strikes than upside - the market pays more for downside puts than equidistant upside calls, because it fears crashes more than melt-ups and buys protection against them. This 'skew' or 'smirk' is the market pricing an asymmetric distribution: more probability, or more feared severity, on the downside. It is persistent, it reflects genuine asymmetry in how equities move (down fast, up slow - the equities track's lesson), and it is information about where the market prices risk.

What the skew reads

The market's fear: a steep downside skew means the market is paying heavily for crash protection - elevated fear priced into downside strikes; the skew's steepness is a fear gauge, read across the chain. The asymmetry priced: the skew is the distribution's asymmetry (module 2) made visible strike by strike - the market's view that the underlying's risks are lopsided, usually toward the downside for equities. The relative value: an option on the steep side of the skew is expensive relative to one on the flat side - so the skew informs which strikes carry rich or cheap volatility, refining the volatility judgement across strikes.

Using the skew in a view

The skew refines the volatility judgement into a shape: buying a downside put pays the elevated skew (expensive protection the market already prices); buying an upside call may pay less relative volatility; and a structure spanning strikes (module 5's spreads) trades one part of the skew against another. Reading the skew says whether the specific strike a view needs is expensive or cheap relative to the chain, and what the market's asymmetric fear is pricing. Module 8 gives the skew and the smile their full treatment; the analysis module reads the skew as information - the volatility judgement extended across strikes, showing where the market prices its asymmetric risk, and what it fears.

Check your understanding

1. What does the typical equity skew show?

- a. Higher volatility on upside strikes
- b. Higher implied volatility on downside strikes - the market pays more for downside protection, fearing crashes more than melt-ups, pricing an asymmetric distribution
- c. Equal volatility across strikes

Answer: b. The skew or smirk reflects genuine equity asymmetry - down fast, up slow - and the market's fear of crashes. Its steepness is a fear gauge, read across the chain.

2. How does the skew refine the volatility judgement?

- a. It replaces it with direction
- b. It shows whether the specific strike a view needs is expensive or cheap relative to the chain - the volatility judgement extended across strikes into the distribution's asymmetric shape
- c. It sets the expiry

Answer: b. The skew is the priced asymmetry, strike by strike. Reading it says where volatility is rich or cheap and what the market's lopsided fear is pricing.